

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
FESTIVAL LEASEHOLD CO.	:	DETERMINATION
for Revision of a Determination or for Refund	:	
of Tax on Gains Derived from Certain Real	:	
Property Transfers under Article 31-B of the	:	
Tax Law.	:	

Petitioner, Festival Leasehold Co., c/o A. Walter Socolow, 445 Park Avenue, New York, New York 10022, filed a petition for revision of a determination or for refund of tax on gains derived from certain real property transfers under Article 31-B of the Tax Law (File No. 804334).

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York on September 17, 1987, with all briefs to be submitted by November 26, 1987. Petitioner appeared by Sheber, Pomerantz and Slotnick, Esqs. (A. Walter Socolow, Esq., of counsel). The Audit Division appeared by William F. Collins, Esq. (Paul A. Lefebvre, Esq., of counsel).

ISSUES

I. Whether petitioner's assignment of its sublease of certain premises constituted a transfer subject to tax under Tax Law Article 31-B.

II. Whether, if so, petitioner has established that the consideration received for its transfer of the aforementioned sublease totalled less than one million dollars, thereby entitling petitioner to exemption from tax pursuant to Tax Law § 1443.1, or that the consideration received was less than petitioner's original purchase price thus leaving no "gain" subject to tax.

FINDINGS OF FACT

1. Petitioner, Festival Leasehold Co. (the successor-in-interest to Mage Films Inc.), was the tenant under a certain sublease (the "subject sublease") with Fashion Management Corp. ("Fashion Management"), as landlord. This sublease, entered into on October 26, 1961, covered the street floor (store, theater and mezzanine) and basement areas of a fourteen story building located at 6-8 West 57th Street, New York, New York. This sublease was to run, by its terms, from its date of execution (October 26, 1961) through July 29, 1998, and further allowed for renewals and/or extensions thereof for an additional period of 21 years (from July 30, 1998 through July 29, 2019).

2. This subject sublease was itself a sublease of Fashion Management's own lease of the same premises dated October 29, 1960 between 6 West 57th Street Leasehold (as successor in interest to The Milton Co.), as landlord, and Fashion Management as tenant. In turn, underlying this lease was 6 West 57th Street Leasehold's lease of the entire building from Messrs. Paul

Green and George S. Shultz pursuant to a master lease dated August 5, 1956.

3. On December 5, 1985, pursuant to an Agreement of Purchase and Sale of Sublease (the "Agreement") and an Assignment of Lease, petitioner transferred by assignment all of its rights, duties and obligations under the subject sublease to 57th Street Realty Corp. as purchaser. Pursuant to the terms of the Agreement, dated July 11, 1985, the purchase price for the assignment, per paragraph 4.1, was set at \$900,000.00, and was to be payable as follows:

"(a) The sum of \$100,000 will be payable to [petitioner] on the Closing Date by certified or bank check or checks.

(b) The balance of \$800,000 (the "Balance") shall be payable to [petitioner], without interest, by certified or bank check or checks on the earlier of (i) the third anniversary of the Closing Date, or (ii) the date on which [57th Street Realty Corp.] or any subtenant of [57th Street Realty Corp.], ...opens for business at the Subject Premises for non-theater purposes. [57th Street Realty Corp.] will deliver to [petitioner] on the Closing Date its promissory note or notes in the amount of the Balance (the 'Note'), payable in accordance with the preceding sentence."¹

4. At the time of the December 5, 1985 transfer petitioner paid, under protest, tax under Article 31-B ("gains tax") in the amount of \$26,671.90. Thereafter, on April 25, 1986, petitioner filed a claim seeking a refund of this amount of tax paid under protest, plus interest. The stated basis of petitioner's claim for refund was that the \$800,000.00 face amount of the promissory note mentioned above should be discounted to its market value as of the date of the transfer. Petitioner claims such discounting would reduce the principal amount of the note to a level whereby the overall transaction would result in a loss rather than a gain.

5. By a letter dated November 6, 1986, the Audit Division denied petitioner's claim for refund. In its denial letter, the Audit Division presented its calculation of petitioner's gain, and the resultant tax liability on the subject transfer as follows:

**Amount of Assignment	\$ 900,0000
Value of Remaining Rental Payments	<u>1,276,633</u>
Total Consideration	2,176,633
Original Purchase Price	<u>1,909,917</u>
Gain	266,716
10% Tax	26,671.60"

The letter also explained the basis for the denial as follows:

"Section 590.31 of the New York State Transfer Gains Tax Regulations states that the consideration for the assignment of a lease is 'the amount received for such

¹Pursuant to paragraph 4.2 of the Agreement, this Promisory Note was to be secured by 57th Street Realty Corp.'s provision of a letter of credit in favor of petitioner.

assignment. However, to apply the \$1,000,000 exemption and for purposes of filing requirements, the value of the remaining rental payments required to be made pursuant to the terms of the lease must be added to the consideration for the assignment.'

*Pursuant to Section 4.1 of the purchase agreement, the total purchase price is \$900,000, without interest. Section 590.12 of the New York State Transfer Gains Tax Regulations states that where the price paid for real property is in the form of cash and a mortgage, the consideration is the 'sum of the cash and the face amount of the mortgage'." (Emphasis as in original.)

7. Petitioner timely filed a petition to commence the instant proceeding. At hearing, in addition to presenting its arguments with respect to this case, petitioner's representative requested a period of time, post-hearing, to obtain an opinion by a New York City bank as to the value of the \$800,000.00 promissory note. More specifically, petitioner desired to obtain an opinion as to the appropriate discounted value, on December 5, 1985, of an \$800,000.00 promissory note payable pursuant to the terms outlined in Finding of Fact "3". By a letter dated September 29, 1987 to Chase Manhattan Bank, N.A., petitioner's representative requested an evaluation of the market value of a note such as that described herein. The Bank's response to petitioner's request was to refer petitioner's representative to Chase Manhattan Valuation Consultants with the explanation that the main office of the Bank was not the proper party for providing such an evaluation.

8. By a letter and brief dated October 7, 1987 petitioner's representative advised, in essence, that the expense to obtain such an opinion of the market value of the note was not an expense petitioner was willing to undertake in this matter. Said letter also notes, in contrast to the 14% discount factor mentioned in petitioner's refund claim, an assertedly appropriate discount factor of 22%.

SUMMARY OF PETITIONER'S POSITION

9. The main thrust of petitioner's argument is that since the note was structured as a non-interest bearing note, petitioner would only have received the face value of \$800,000.00 if payment had been made on the date of transfer. Petitioner asserts that inasmuch as payment did not occur on the date of transfer, it is thus reasonable to discount the face amount of such note to arrive at its present value as of the date of the transfer. In turn, petitioner maintains that such calculation would result in a value which, when combined with the value of the remaining rental payments under the lease, would leave the total consideration at an amount less than petitioner's original purchase price for the subject sublease and thus not subject to gains tax. Petitioner maintains in this vein that the manner of structuring the note reflects the fact that there was substantial litigation surrounding the subject sublease and the manner and use of its subject premises. Petitioner asserts that the allowance of a three-year period without interest reflected the uncertainties held by the assignee (57th Street Realty Corp.) as to when, or even if, it would be able to lease the premises and generate rental income.

10. Finally, petitioner raised (at hearing) the argument that the subject sublease was for a period of less than 49 years and hence was not a taxable sublease pursuant to the terms of Tax Law Article 31-B.

CONCLUSIONS OF LAW

A. That Tax Law § 1441, which was effective as of March 28, 1983, imposes a tax at the rate of 10% upon gains derived from the transfer of real property within New York State. In turn, "gain" is defined by Tax Law § 1440.3 as "the difference between the consideration for the transfer of real property and the original purchase price of such property, where the consideration exceeds the original purchase price".

B. That included among those items constituting an "interest" in real property is, inter alia, a leasehold interest (Tax Law § 1440.4). In turn, Tax Law § 1440.7 defines "transfer of real property" as "the transfer...of any interest in real property by any method, including...assignment...." Further, said section specifically includes the "creation of a leasehold or sublease" as a "transfer of real property", but affirmatively limits the imposition of gains tax thereon to instances where:

"(i) the sum of the term of the lease or sublease and any options for renewal exceeds forty-nine years,

(ii) substantial capital improvements are or may be made by or for the benefit of the lessee or sublessee, and

(iii) the lease or sublease is for substantially all of the premises constituting the real property." (Tax Law § 1440.7.)

C. That with respect to the first issue raised herein, petitioner argues that the transfer in question is not subject to gains tax because the subject sublease was for a period of less than 49 years. It does not appear that petitioner maintains the transfer of a leasehold interest (including a sublease) the term of which is for a period in excess of 49 years would not be subject to tax, nor is there any argument raised by petitioner that the subject sublease does not fulfill the two criteria enumerated in the above-quoted subsection (Tax Law § 1440.7) under items (ii) and (iii).

D. That 20 NYCRR 590.56 provides as follows:

"Assignment of a lease. [Tax Law, § 1440(4), (6), (7)]

Question: Is an assignment or surrender of a lease taxable?

Answer: Yes, regardless of the term of the lease assigned or surrendered".

E. That with respect to petitioner's assertion concerning the duration of the subject sublease as being less than 49 years, it is noted that Tax Law § 1440.7 speaks to "the term of the lease or sublease and any options for renewal" (emphasis added). The facts in this matter reveal that the subject sublease was entered into on October 26, 1961, was to run through July 29, 1998, and also called for renewal terms of up to 21 years (from July 30, 1998 through July 29, 2019).²

²It should be noted that a copy of the sublease itself was not submitted in evidence or otherwise included as a part of the record. However, Exhibit

The inclusion of the extension period of up to 21 years clearly reveals that the subject sublease was for a total term well in excess of 49 years (to wit, a total term of approximately 58 years).³ Accordingly, not only upon the basis of the above-cited regulation (20 NYCRR 590.56), but also in light of the specific facts of this case, petitioner's argument that the subject sublease fails to fall within the definitional parameters of a lease or sublease subject to taxation under Article 31-B is clearly without merit and is rejected.

F. That, turning to the second issue presented, Tax Law § 1440.1(a) defines "consideration" as follows:

"Consideration means the price paid or required to be paid for real property or any interest therein....Consideration includes any price paid or required to be paid,...including the amount of any mortgage, purchase money mortgage, lien or other encumbrance, whether the underlying indebtedness is assumed or taken subject to. Consideration includes the cancellation or discharge of an indebtedness or obligation." (Emphasis added.)

G. That Tax Law § 1440.1(b) further provides, with respect to "consideration", that:

"[i]n the case of...(ii) the creation of a leasehold or sublease that is a transfer of real property, as defined in subdivision seven of this section, consideration shall also include the value of the rental and other payments attributable to the use and occupancy of the real property or interest therein and the value of any option to purchase or renew included in such transfer." (Emphasis added; see also Tax Law § 1443.1[c], infra.)

H. That Tax Law § 1443, insofar as relevant to this matter, provides as follows:

"A total or partial exemption shall be allowed in the following cases:

"G" introduced in evidence at the hearing contains evidence as to the terms of the subject sublease, including specifically the duration of extensions allowable thereunder. In addition, certain of the other Exhibits, as well as the Audit Division's post-hearing Memorandum of Law, contain references to the terms of the sublease which are neither challenged nor disputed by petitioner's representative and hence are accepted as accurate for purposes of this determination.

³Tax Law § 1440.7(i) speaks of the "term" of the lease or sublease plus renewal options without including any restrictive or limiting language such as "remaining term".

1. If the consideration is less than one million dollars; provided, however, for the purpose of the application of this exemption only, consideration shall be deemed to also include:

* * *

(c) In the case of an assignment of a lease by the lessee, the value of the remaining rental payments required to be made pursuant to the terms of such lease." (Emphasis added.)

I. That pursuant to Tax Law §§ 1440.1, 1440.7 and 1443.1(c), together with 20 NYCRR 590.31(a), the consideration received with respect to (the assignment of) a leasehold or sublease is to be determined by adding together the cash received, the amount of the note and the value of the remaining rental payments (see 52 Fulton Street Distributors, Ltd. v. State Tax Commn., Albany County, Special Term, July 20, 1987, Williams, J.).

J. That while the statute speaks solely of the term "value" with respect to remaining rental payments, it is plain from a reading of 20 NYCRR 590.26 and 590.27, as well as Matter of 52 Fulton Street (supra) that the concept of "present value" is incorporated into the determination of such "value". Also of relevance here is that for purposes of computing the present value of the rental payments during the term of a lease or sublease, 20 NYCRR 590.26 calls for a 10% discount rate to be presumed for gains tax purposes, unless the taxpayer can demonstrate that 10% does not adequately reflect the discount factor in his particular circumstances, in which case a different percentage may be used.

K. That the Audit Division initially valued the remaining rental payments at face value, specifically, \$1,276,633.00, such being the remaining total dollar amount of rent to be paid over the balance of the subject sublease's term. Although as noted a copy of the subject sublease was not provided in evidence, petitioner averred at hearing that the terms thereof called for annual rental payments. By its brief, the Audit Division provided present value figures for the sum of the remaining rental payments at a discount of 10%. The Audit Division sums said present values as: (a) \$769,934.00, utilizing a 13-year period and computing the value on a monthly rather than annual basis; (b) \$815,964.00, when computed on a 13-year annual rather than monthly basis; or (c) as \$850,653.00, using a 12-year annual computation.

L. That with respect to the \$800,000.00 promissory note, petitioner asserts that said note should be discounted to give effect to its present value as of the date of the assignment. Inasmuch as no rate of interest was called for under the note, petitioner asserts that the appropriate means of valuation is to utilize a discount factor reflective of the value, as of the date of closing, of the right to receive \$800,000.00 three years hence. Petitioner has suggested two possible percentages to use for discount, either 14% or 22%. By contrast, the Audit Division maintains that the full face amount of the promissory note, to wit \$800,000.00, should be used for purposes of computing consideration.

M. That since any tax due on the transfer at issue would have been payable on the date of such transfer (see Tax Law § 1442), and given the specific language of Tax Law § 1440.1(a) wherein the term "amount" is used as opposed to the term "value" (as found in Tax Law § 1440.1[b] with respect to rental payments), it is proper to include the full face amount of the note as consideration. To allow otherwise would be to set the stage for abuse via the structuring of transactions involving financing arrangements with unrealistically high discounts (or interest rates) resulting in unrealistic valuations of the consideration received. While petitioner may have

had valid business reasons for structuring the method of payment as set forth, petitioner is likewise bound by the consequences flowing therefrom. Under the terms of the Agreement, petitioner could have received the proceeds of the note at any time from the date of the closing through the end of three years thereafter. Thus, even if discounting were allowable the valuation herein would at best be highly speculative (i.e. based essentially on the sublease assignee's possibility of acquiring a tenant within three years of closing). Further, even if petitioner's argument that a three year discount back to date of transfer was acceptable in this instance, petitioner has offered no evidence or basis in this matter as to the appropriate rate of discount other than its own opinions of 14% or 22%.

N. That based upon the foregoing, consideration for the assignment of the subject sublease properly included the full \$800,000.00 face amount of the note, the present value of the remaining rental payments and the \$100,000.00 in cash transferred at closing. Accordingly, to compute the total consideration the value of the remaining rental payments must be adjusted to reflect a present value computation with respect thereto. By reference to Conclusions of Law "J" and "K", it is appropriate to discount at 10% and to do so on a 13-year annual payment basis, thus resulting in a present value for the lease payments of \$815,964.00. Accordingly, the total consideration for the transfer in question is \$1,715,964.00, computed as follows:

Amount of Assignment (Cash)	\$ 100,000.00
(Note)	800,000.00
Value of Remaining Rental Payments	815,964.00
Total Consideration	\$1,715,964.00

O. That since the total consideration as computed above exceeds one million dollars, the exemption afforded by Tax Law § 1443.1 is not available to petitioner. However, since petitioner's original purchase price of \$1,909,917.00 (see Finding of Fact "5") is greater than the total consideration received, there is no "gain" to petitioner on this transfer upon which to impose the tax (see Tax Law § 1440.3). Accordingly, petitioner is entitled to a refund of the gains tax paid upon transfer.

P. That the petition of Festival Leasehold Co. is hereby granted and the Audit Division is directed to refund to petitioner the amount of gains tax paid together with interest thereon.

DATED: Albany, New York
May 19, 1988

_____/s/
ADMINISTRATIVE LAW JUDGE